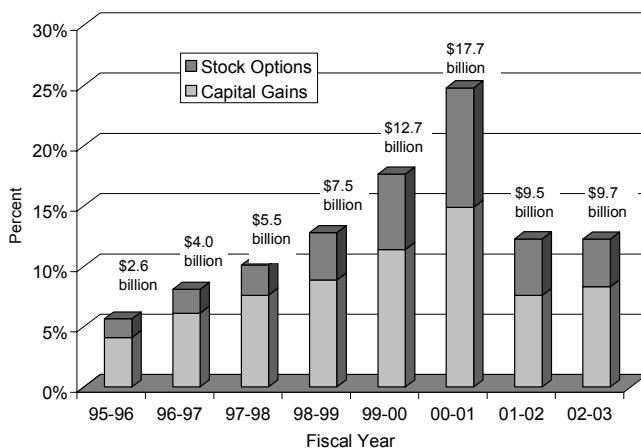


California's Economic Challenge

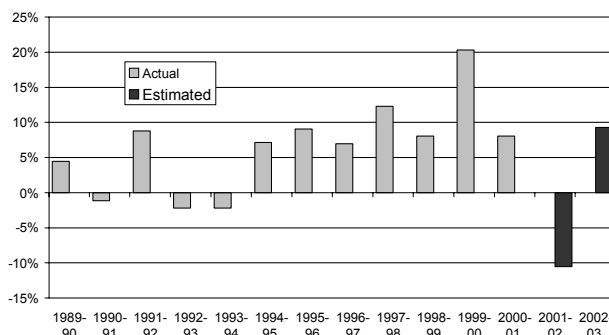
National economic developments in 2001 included the beginning of a recession, ending the longest economic expansion in our nation's history. But unlike the recession in the early 1990s, California's economy has shown great resilience through this downturn, continuing to outpace the nation in job growth through much of 2001. By the fall, however, signs of the economic slowdown were pronounced, forcing job losses in major sectors of the economy. The international economic climate also slowed, depressing sales of California exports, and the terrorist attacks in September dealt a severe blow to California industries most dependent on tourism.

Figure A
Capital Gains and Stock Options Revenue as a Percent of Total General Fund Revenue



Note: An assumed tax rate of 9 percent was used to calculate the tax revenue from capital gains and stock options.

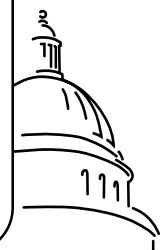
Figure B
Major General Fund Revenue Growth 1989-90 to 2002-03



The impact of all of these factors on California's economy and revenue outlook is magnified by the extraordinary rise and fall of the stock market, particularly in the high-technology sector, and the extreme volatility of the income tax revenues from capital gains and stock options.

The volatility of stock market-related income is the most significant financial factor influencing California's budget in 2002-03. Over the last three years, the stock market and, in particular, the technology-driven NASDAQ index soared to unprecedented levels, rewarding investors and employees with huge profits. The resulting capital gains and stock option income created an unprecedented surge in State tax revenues (Figure A). But in 2001, the reverse happened, and the steep decline in the stock market, capital gains, and stock option income, coupled with the impact of September 11, produced the most precipitous decline in revenues since World War II (Figure B).

California's Economic Challenge



Recognizing the volatile nature of revenue generated by the stock market, the Administration and Legislature took steps to guard against a sudden reversal in revenue by investing a significant portion of the increased funds in one-time expenditures such as infrastructure and capital improvements instead of on-going program commitments, and by augmenting the Reserve for Economic Uncertainties to its highest level in more than two decades. However, the sharpness of the decline in revenue was beyond all projections and will deplete the Reserve, resulting in a shortfall of \$3 billion in the current year. This problem combined with a reduced estimate of capital gains and stock market income for the budget year and the need for a reserve means that the State must close a funding gap exceeding \$12 billion by June 30, 2002.

The strength and diversity of California's economy in the last three years made it possible to make major strides in critically important areas – education, public safety, the environment, and expanding health care coverage to California's most vulnerable citizens. And it is the same strength and diversity of California's economy that will enable California's political leaders to address the current fiscal challenge without retreating on gains we've made or destroying vital safety net programs designed to protect Californians in troubled times.

The Governor's Proposed Budget presents a combination of tough decisions necessary to reduce spending in the current year and budget year, and prudent fiscal measures designed to address a sharp revenue shortfall resulting from the effects of a national recession and the terrorist attacks in September. This fiscal recovery plan ensures that the State's most important achievements are not sacrificed as the Governor and the Legislature seek to address what experts predict to be a moderate economic downturn. The expectation of a mid-year recovery for the California economy is very close to what both the University of California, Los Angeles (UCLA) and the Legislative Analyst are expecting based on their year-end forecasts. It is predicated on an outlook for the national economy that is also similar to those of UCLA and the Legislative Analyst, but marginally weaker than the Blue Chip forecast, which is based on a survey of 51 business economists throughout the nation. If the economic recovery is delayed, thereby protracting the rebound in State revenues, additional measures will be necessary to ensure the State's fiscal condition remains strong, stable, and balanced.

As the magnitude of the current fiscal challenge facing the State became more evident in Fall 2001, the Administration took steps to reduce spending in the current year by administratively "freezing" approximately \$2.2 billion in General Fund expenditures and transmitting its *Proposed Reduction in 2001-02 Spending* plan to the Legislature in November 2001. The 2002-03 Budget proposes additional spending reductions and other strategies to provide General Fund relief totaling \$12.5 billion.



Essential programs providing core services were protected from significant reductions, including K-12 education, public safety, and health coverage for children and low-income families, as were those programs that will provide an immediate stimulus to the state's economy.

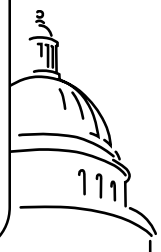
The Governor's Proposed Budget for 2002-03 fully funds the Proposition 98 guarantee and provides full growth and cost-of-living adjustments (COLA) for K-12 schools. With the proposed 2002-03 Budget, General Fund spending on K-12 education will increase by \$270 million over 2001-02 for a total increase of nearly \$8 billion, or 34 percent, since 1999. The Governor's Proposed Budget also fully funds critical reform programs implemented in the last three years to address school accountability, improved student performance, and standards-based professional development for teachers and administrators. The Administration has also committed significant additional resources in the 2002-03 Budget to expand before and after school programs and fully fund textbook acquisition in accordance with the scheduled adoption of state standards for instructional materials.

The Governor's Proposed Budget also maintains the tremendous progress California has made in the last three years to reduce the number of children and low-income families without health insurance in California. Since 1999, California has expanded affordable health care coverage to more than 1.8 million Californians including children, low-income families, persons with AIDS, and aged, blind and disabled adults through the Healthy Families Program and the Medi-Cal program.

This Administration has also demonstrated its continuing commitment to public safety by fully funding the Citizens' Option for Public Safety and Juvenile Crime Prevention programs (\$232.6 million), technology grants for local law enforcement (\$35.4 million), small county law enforcement grants (\$18.5 million), the War on Methamphetamine initiative (\$15 million), and high technology crime and identity theft efforts (\$14.4 million).

The Budget continues to provide funds for important environmental initiatives including clean water, parks, land and water conservation efforts and the California Bay-Delta program (CalFED). Investments made by California voters in bond measures for these efforts have allowed the State to continue to protect our natural resources and build for the future even as the economy slows down.

Finally, the Governor's Proposed Budget continues to provide California taxpayers with the record level tax relief enacted in the last three years. By the end of fiscal year 2002-03, California taxpayers will have received an additional \$4.5 billion in ongoing tax relief: \$3.7 billion in vehicle license fee reductions, and \$800 million in



targeted tax relief that includes the long-term care and child care credits for families, research and development credit for businesses, and relief from sales tax on fuel and equipment for California farmers.

In spite of the budget shortfall we face, California is stronger today than at any other time in our history. That strength allows California to meet this economic challenge head on. The Governor's Proposed 2002-03 Budget meets the task by continuing to nurture the elements that make our economy strong, reducing spending in response to lower revenues, and protecting the vital services that provide the foundation of California's future.

